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# Introduction to U.S. Economy: Business Investment

## What Is Business Investment?

Business investment is spending by private businesses and nonprofits on long-lasting assets, also known as physical capital, that assist in the production of goods and services. Physical capital is generally grouped into three categories: equipment (e.g., machinery or computers), structures (e.g., offices or warehouses), and intellectual property (e.g., software development or research and development).

Through investment, businesses can build up their stock of physical capital, which increases their capacity to produce goods and services. For example, when a restaurant purchases an additional grill, it increases its capacity to prepare food at a given time. However, physical capital tends to become less productive over time due to wear and tear and eventually must be replaced as it breaks down. This process is referred to as depreciation. For a firm to continually increase its stock of physical capital, and therefore its productive capacity, it must invest in new physical capital faster than its current physical capital is depreciating. The same goes for the economy as a whole—for the economy's stock of physical capital to increase, the investment rate must exceed the rate at which physical capital depreciates.

## Economic Considerations

Business investment is of significant interest to economists because it can affect the economy's short-term and long-term growth.

In the short term, an increase in business investment directly increases the contemporary level of gross domestic product (GDP) because business investment is included in GDP. Similarly, a decrease in business investment will decrease GDP. Business investment is one of the more volatile components of GDP and tends to fluctuate significantly from quarter to quarter.

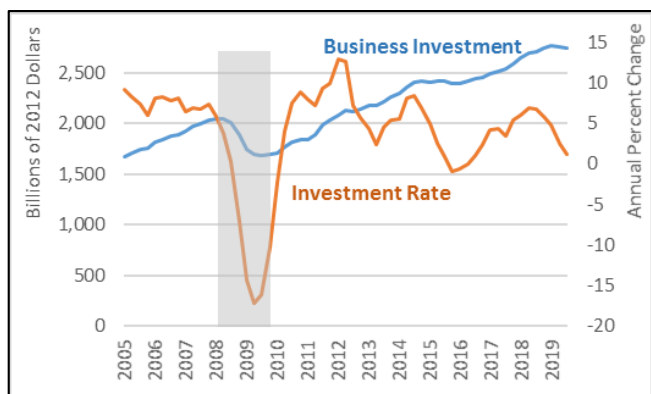
In the long term, business investment, specifically the size of the capital stock, can impact the economy's long-term growth. A higher physical capital stock increases the economy's overall productive capacity, allowing more goods and services to be produced with the same level of labor and other resources. Alternatively, a lower physical capital stock reduces the economy's productive capacity, all else equal. In the long term, economic growth generally depends on growth in the economy's productive capacity, rather than swings in supply and demand. Faster economic growth generally translates into faster income growth and improved living standards. For additional discussion of the long-term drivers of economic growth, refer to CRS In Focus IF10557, *Introduction to U.S. Economy: Productivity*, by Jeffrey M. Stupak.

## Drivers of Business Investment

The main determinants of business investment are broader economic conditions, business confidence and expectations, and long-term interest rates.

As discussed earlier, business investment can affect the economy, but changes in the economy also affect business investment. As shown in **Figure 1**, following the beginning of the 2007-2009 recession, business investment began to decrease sharply. As a recession occurs, businesses tend to see a decline in demand for their products, which leads them to reduce investment spending. Alternatively, during a healthy economic expansion, businesses tend to see rising demand for their products, which leads them to increase investment in order to increase production to accommodate the increased demand. As such, the business cycle is one of the largest drivers of business investment. For more information regarding the business cycle, refer to CRS In Focus IF10411, *Introduction to U.S. Economy: The Business Cycle and Growth*, by Jeffrey M. Stupak.

**Figure 1. Recent Business Investment Trends 2005-2019**



**Source:** Bureau of Economic Analysis.

**Notes:** The investment rate is measured as the year-over-year change in real business investment. Grey bar indicates recession.

Business confidence and future expectations for the economy are also expected to influence business investment. If business owners expect rising sales and improving economic conditions, they are more likely to invest in their businesses because they anticipate increased demand for their goods and services. Alternatively, declining confidence in the economy will likely result in declining business investment. Business confidence and future expectations can be unpredictable and difficult to influence through public policy.

Business investment is typically financed through credit markets. As such, interest rates influence business

investment decisions by either increasing or decreasing the cost for a business to borrow funds, thus affecting the profitability of making additional investments. When a firm is evaluating a potential investment, it must determine whether the expected benefits will outweigh the cost. All else equal, a rising interest rate will increase the costs associated with an investment, resulting in fewer investments being undertaken. Alternatively, a falling interest rate will decrease the costs associated with investment, resulting in more business investment. This concept is the guiding principle behind contemporary monetary policy, with the Federal Reserve altering short-term interest rates in order to influence long-term interest rates in an effort to affect business investment (and interest-dependent consumer spending.) For additional discussion of monetary policy and the Federal Reserve, refer to CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte.

### Saving and Investment

One of the long-term determinants of business investment is the level of savings available to the economy. For financial institutions to loan funds to businesses that the businesses in turn use to make investments, other individuals must be depositing their savings with those financial institutions. Because of the global nature of the U.S. economy, firms in the United States have access to savings from within the United States and from abroad; thus, interest rates in the United States are influenced by the supply of global, in addition to national, savings. A higher supply of savings results in lower interest rates, and a lower supply of savings results in higher interest rates, all else equal. As such, an increase in the supply of savings should lead to an increase in business investment, due to declining interest rates. For additional discussion of the supply of savings, refer to CRS In Focus IF10963, *Introduction to U.S. Economy: Personal Saving*, by Jeffrey M. Stupak.

### Trends in Business Investment

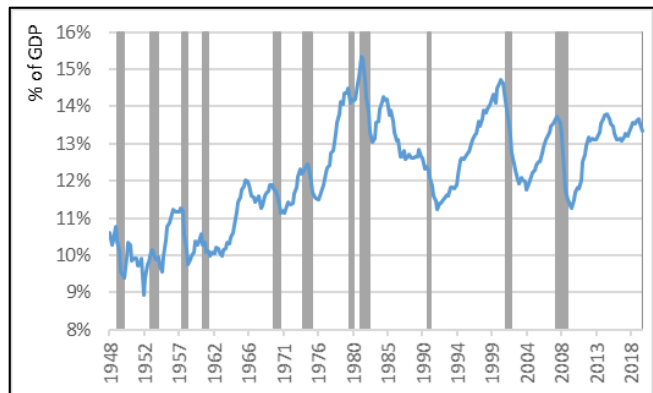
As shown in **Figure 1**, business investment declined sharply during the 2007-2009 recession. Deteriorating economic conditions during the recession reduced business revenues and confidence. The decline in business investment persisted through the third quarter of 2009, despite the Federal Reserve lowering its benchmark interest rate to zero beginning in late 2008. Following the 2007-2009 recession, business investment began rising again, with the year-over-year investment rate peaking around 13% in the first half of 2012. This rise in business investment coincided with historically low interest rates, improving business confidence, and broadly improving economic conditions.

Business investment began to slow considerably by mid-2014, remaining relatively flat between 2014 Q4 and 2016 Q2. This decline in investment coincided with a decline in business confidence, as measured by the Organisation for Economic Co-operation and Development (OECD) business confidence index. Some commentators suggested the decline in confidence resulted from policy uncertainty during the run-up to the 2016 election. Beginning in mid-2016, business investment began increasing again, peaking in mid-2018. Since this peak, investment has slowed though

the rest of 2018 and 2019. The temporary acceleration in business investment was potentially due to increased business confidence and changes to the tax code that made physical capital investment more attractive. For further discussion of the effect of the 2017 tax revision, refer to CRS Report R45736, *The Economic Effects of the 2017 Tax Revision: Preliminary Observations*, by Jane G. Gravelle and Donald J. Marples.

In general, beginning in the late 1970s, business investment as a percentage of GDP increased and has remained elevated, increasing from an average of around 10.8% between 1948 and 1975 to around 13.0% between 1976 and 2019. As shown in **Figure 2**, after falling to about 11.3% by the end of 2009, business investment, as a percentage of GDP, has risen back to pre-recession levels of around 13.4% as of mid-2019.

**Figure 2. Historical Business Investment Trends 1948-2019**



**Source:** Bureau of Economic Analysis.

**Notes:** Grey bars indicate recessions.

### Foreign Investment

Business investment in the United States is made by both domestic and foreign individuals. The United States receives significant foreign direct investment from abroad, amounting to about \$296.4 billion in 2018, according to the Bureau of Economic Analysis. By this measure, the largest foreign investors in 2017 were Germany, Ireland, and Canada. In addition to foreign direct investment, individuals from abroad can invest in U.S. financial assets that can provide U.S. businesses with funds to finance physical capital investment.

Foreign investment in the United States has been trending downward over the past several years, declining from its postrecession peak of about \$439.5 billion in 2015. However, the United States is not alone in experiencing a decline in foreign investment. According to the OECD, global foreign investment declined about 20% in the first half of 2019.

(Note: This In Focus was originally authored by Jeffrey Stupak, former CRS Analyst in Macroeconomic Policy.)

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